Office-Supreme Court, U.S.
FILED
SEP 3 1981
ALEXANDER L. STEVAS,
CLERK

No. 81-99

In the Supreme Court of the United States

OCTOBER TERM, 1980

AARON L. KOLOM AND SERITA KOLOM, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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Petitioners seek review of the decision in this income tax case holding that petitioner Aaron L. Kolom's[1] exercise of a "qualified" stock option gave rise to an "item of tax preference" for minimum tax purposes under Section 57(a)(6) of the Internal Revenue Code of 1954 (26 U.S.C.) in the amount of the difference between the option price and the price at which such stock was publicly traded on the date of exercise.

The pertinent facts may be summarized as follows: Petitioner was an officer and director of Tool Research and Engineering Corporation, the stock of which was traded on

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[1] References to "petitioner" are to Aaron L. Kolom. Serita Kolom is a party solely because she joined in filing a joint tax return for the year in question.

the New York Stock Exchange. In 1968, 1970 and 1971, Tool Research granted petitioner options to purchase varying amounts of the company's stock at specified prices pursuant to an employees' stock option plan meeting the "qualification" requirements of Section 422 of the Code. During the year in issue (1972), petitioner acquired the following Tool Research shares on the exercise of those option rights:

Date of exercise	Number of shares	Mean publicly traded price per share	Option price per share
9/15/72	6,678	$52.00	$13.25
10/05/72	4,174	$45.25	$12.00
10/05/72	1,575	$45.25	$19.625

While the stock so acquired could have been freely traded from the outset, petitioner, as a director and officer of Tool Research, could have been required, under the provisions of Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), to give up all or part of the profit enjoyed on any resale of the stock within six months after it was acquired (Pet. App. 18-20).[2]

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[2]Under Section 16(b), officers, directors, and major shareholders of a public corporation may be required to relinquish all or part of profits derived from "short-swing" insider trading, such as the gains accruing from a sale of their corporation's stock within six months of purchase. The measure of profit which must be relinquished is limited, however, by SEC Rule 16b-6, 17 C.F.R. 240.16b-6. Under that rule, an insider will never be required to pay over more than the excess of the sale proceeds over the lowest quoted market price of the stock six months before or after the sale.

Petitioner's federal income tax return for 1972 contained a computation of minimum tax liability which did not take into account any amount with respect to his exercise of stock options.[3] On audit, the Commissioner of Internal Revenue determined that the difference between the option price and the fair market value of the stock, as determined by reference to the exchange price for such stock on the respective dates of exercise, represented an "item of tax preference" required to be taken into account in computing minimum tax liability under Section 57(a)(6) of the Code. In a reviewed decision, the Tax Court upheld the Commissioner's determination (Pet. App. 20-40). The court of appeals affirmed (Pet. App. 1-16).[4]

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[3]Petitioner's return disclosed the transactions in question, but contained a statement that they were not taken into account in the computation of minimum tax because of the "short-swing" profit rules of Section 16(b).

[4]The Tax Court majority rejected petitioner's contention that the exchange price should be discounted because of his potential liability under the short-swing profit rule of Section 16(b). In so ruling, the court noted (Pet. App. 28) that the stock could have been sold at any time and that it should therefore be valued on the basis of the exchange price, even without regard to the Regulations providing that, for the purpose of Section 57(a)(6), the fair market value of qualified option stock is to be determined without regard to temporary trading restrictions. Treasury Regulations on Income Tax, Section 1.57-1(f)(3) (26 C.F.R.). Two judges disagreed with the majority's analysis, but nevertheless concurred on the ground that petitioner had failed, in any event, to establish an appropriate discount factor based on the short-swing profit rules of Section 16(b) (Pet. App. 39-40). The court of appeals agreed with the analysis of the Tax Court majority, and further concluded that the Commissioner's Regulations are valid (Pet. App. 8-15).

1. The decision below correctly held that the proper measure of the "item of tax preference" under Section 57(a)(6) on the exercise of a qualified stock option is the difference between the option price and the market price on the date of exercise, without regard to potential "short swing" profit liability under Section 16(b) of the Securities Exchange Act of 1934. It is, moreover, in accord with the only other two decisions on point. See *Harrison* v. *United States*, 620 F. 2d 288 (3d Cir. 1980), aff'g 475 F. Supp. 408 (E.D. Pa. 1979); and *Thomsen* v. *United States*, 47 A.F.T.R. 2d 81-934 (N.D. Iowa Feb. 5, 1981).

Ordinarily, a taxpayer exercising an option received in connection with his employment is taxable, in the year of exercise, on the difference between the option price and the fair market value of the property, determined without regard to the existence of temporary trading restrictions (including restrictions under the securities laws). Section 83(a) of the Code; Treasury Regulations on Income Tax, Section 1.83-3(h) (26 C.F.R.). See *Sakol* v. *Commissioner*, 574 F. 2d 694 (2d Cir.), cert. denied, 439 U.S. 859 (1978); *Pledger* v. *Commissioner*, 641 F. 2d 287 (5th Cir. 1981), petition for cert. pending, No. 81-157; cf. *Commissioner* v. *LoBue*, 351 U.S. 243 (1956).

By contrast, under the statutory provisions in effect during the period here in question, no income was recognized on the exercise of a stock option granted pursuant to a plan meeting the "qualification" requirements of Section 422 of the Code, as long as the employee retained the stock acquired for at least three years. Sections 421(a) and 422(a) of the Code. Moreover, any gain on the ultimate disposition of the stock would be taxed at capital gains rates. In light of the substantial tax benefits thus accorded the recipients of "qualified" stock options, Congress has required that the "bargain element" enjoyed on exercise of such an option—*i.e.*, "the amount by which the fair market value of the share

at the time of exercise exceeds the option price"—be treated as an "item of tax preference" for minimum tax purposes. Section 57(a)(6) of the Code. See S. Rep. No. 91-552, 91st Cong., 1st Sess. 114 (1969). The Regulations under Section 57 specifically provide, in accordance with the principles applicable under Section 83, that "the fair market value of a share of stock received pursuant to the exercise of a qualified * * * stock option is to be determined without regard to restrictions (other than nonlapse restrictions within the meaning of § 1.83-3(h))." Treasury Regulations on Income Tax, Section 1.57-1(f)(3) (26 C.F.R.).

The court of appeals upheld the validity of this Regulation, under which the option stock in question must be valued on the basis of the exchange price on the date of exercise even if the "short-swing" profit rule of Section 16(b) would otherwise be considered a "restriction" to be taken into account in determining fair market value. (Pet. App. 8-12). Accord: *Harrison* v. *United States, supra.* In light of that holding, there is no basis for petitioner's contention (Pet. 6-10) that the decision below conflicts with *MacDonald* v. *Commissioner*, 230 F. 2d 534 (7th Cir. 1956), and similar decisons rendered before the enactment of Sections 57 and 83, holding that the effect of temporary trading restrictions should be considered in determining fair market value.[5] Indeed, it was the purpose of Section 83,

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[5]To be sure, the Tax Court majority here concluded (correctly we submit) that Section 16(b) did not impose a restriction on the transfer of the shares in question and that the shares should therefore be valued on the basis of the exchange price even without regard to Section 1.57-1(f)(3) of the Treasury Regulations, because Section 16(b) would not itself have affected "the price at which the property would change hands" had petitioner offered it for sale on the open market. Cf. *United States* v. *Cartwright*, 411 U.S. 546, 551 (1973). The court of appeals agreed with this rationale as an alternative basis for its conclusion. (Pet. App. 12-15). See also *Harrison* v. *United States, supra*, 475 F. Supp. at 415; *Thomsen* v. *United States, supra*, 47 A.F.T.R. at 81-937. But even if this had been the sole basis for its decision, there would be no conflict

which was added to the Code in 1969, to overrule such decisions in the case of employee options. See *Sakol* v. *Commissioner, supra*, 574 F. 2d at 698. The Regulation in question adopts the same special valuation rule as that provided in Section 83, thereby ensuring that the amount taxed as a "preference" item for minimum tax purposes under Section 57 (which was adopted at the same time as Section 83) is the same amount that would be included in gross income but for the preferential treatment allowed under Sections 421 and 422 of the Code.

Petitioner, however, argues (Pet. 10-13) that Section 83(e)(1) of the Code, which provides that Section 83 shall not apply to a transaction to which Section 421 applies, directly prohibits adoption of such a valuation rule for minimum tax purposes. But the provisions of Section 83(e)(1) serve only to ensure that Section 83 does not affect the preferential tax treatment accorded qualified options under Sections 421 and 422. The court of appeals correctly noted (Pet. App. 9) that neither Section 83(e)(1) nor the legislative history indicates that the valuation rule set forth in Section 83 would not also be appropriate for minimum tax purposes. Accord, *Harrison* v. *United States, supra*, 475 F. Supp. at 412-414. Indeed, it is reasonable to infer that Congress affirmatively intended that the amount treated as an "item of tax preference" reflect the amount actually excluded from gross income by virtue of Sections 421 and 422. Moreover, the minimum tax on the exercise of qualified options could otherwise easily be avoided by the use of

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with *MacDonald* or the other cases cited by petitioner. *MacDonald* involved an actual restriction on the transfer of the stock in question (230 F. 2d at 539). While the court there did discuss the impact of Section 16(b) (230 F. 2d at 539-541), it specifically recognized, as the court below noted (Pet. App. 14), that consideration of the Section 16(b) issue was not essential to its holding (230 F. 2d at 540).

temporary restrictions similar to those which led to the enactment of Section 83.[6]

2. Petitioner also argues (Pet. 13-18) that the regulation in question unconstitutionally imposes a minimum tax on the basis of a conclusive presumption of fact, allegedly in violation of the Due Process Clause of the Fifth Amendment. The rule set forth in that Regulation, however, is precisely the same as that set forth in Section 83 itself, and it has been uniformly held that Section 83 does not violate the Due Process Clause, even though it may result in the imposition of a tax on the receipt of property in an amount in excess of its immediately realizable value. *Pledger* v. *Commissioner, supra; Sakol* v. *Commissioner, supra.* As the Second and Fifth Circuits held in those cases, and as the court below agreed as well, the requirement that temporary restrictions be disregarded for these purposes is neither arbitrary nor capricious, but is rationally related to the purpose of the taxing provisions in question. It therefore fully complies with the constitutional requirements of due process.

3. At all events, even if petitioner's legal arguments were meritorious, his failure to establish an appropriate discount factor reflecting the effect of potential liability under Section 16(b) constitutes an alternative ground in support of the decision below. At trial, petitioner relied simply on the theory that the "fair market value" of the option stock could not exceed the option price. But that contention is refuted by the facts that any "restriction" imposed by Section 16(b) would expire after six months and that Section 16(b) liability would not, in any event, necessarily encompass the entire

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[6]In fact, disrefarding such temporary stock restrictions is particularly appropriate in the context of the minimum tax since taxpayers exercising qualified options presumably intend to hold their option stock for at least three years, in any event, in order to benefit from the tax advantages of the option. See Section 422(a)(1) of the Code.

"spread" between the option price and the market price on the date of exercise. See page 2, note 2, *supra*. As the concurring judges in the Tax Court concluded, this failure of proof required that the deficiency would have to be sustained even if petitioner's legal contentions were otherwise accepted.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

SEPTEMBER 1981

DOJ-1981-09